THE STABILITY AND GROWTH PACT IN RAINY DAYS: AN ALTERNATIVE VIEW*

Antimo Verde§

Abstract. According to many economists, including those of the European Commission, the serious crisis which befell the Stability and Growth Pact has its roots in the incorrect behaviour of Member States which dissipate resources during economic upswings, thus foregoing an improvement in the budgetary balance to cushion the effects of an eventual downturn. This paper discusses an alternative view which attributes the crisis to the persistently low growth in the European Union. This leads to a proposal for reform of the Pact based on the idea that if the GDP growth of a Member State is very low, the high-quality growth-inducing government expenditure on infrastructure, research and technological innovation would not be considered for the purposes of computing its fiscal deficit. The objectives of this proposal are to make the escape clause of the Pact useable in practice and to avoid forcing member states to give up high quality-spending, which is important for growth and for long-term fiscal sustainability, merely to meet the constraints of the Pact.

Introduction

On November 25, 2003 a serious crisis shocked the Stability and Growth Pact (hereafter SGP or Pact). The EU Council of Finance Ministers (ECOFIN, or Council) decided to “hold in abeyance” the Excessive Deficits Procedure (EDP)—which is a fundamental hinge of European fiscal rules—against France and Germany. The crisis occurred when these countries found themselves in a protracted phase of low growth during which fiscal tightening was difficult to implement.

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According to many economists, including those of the European Commission, this crisis was due to the incorrect behaviour of the Member States which dissipated resources during economic upswings thus foregoing an improvement in the budgetary balance to cushion the effects of an eventual downturn. This paper discusses an alternative view which attributes the crisis to the persistently low growth in the European Union, out of which stems a proposal for an alternative provision within the Pact to cater for rainy days, i.e. periods of inadequate economic growth.

This debate is crucial at this juncture because low growth will probably characterise the Eurozone economy for a relatively long time. This creates a serious risk of another crisis for the Pact. Table 1 shows that at least six Member states could breach the 3 per cent reference value for the fiscal deficit to GDP ratio in 2004. A new crisis would have serious consequences for the Pact and its future applicability, which in turn threatens the viability of the EMU project.

The paper is structured as follows. The next section assesses the extent to which the Pact is in practice applicable in rainy days through the implementation of appropriate fiscal policy over the business cycle and through the existence of a sufficient degree of flexibility in its implementation. This leads to a discussion on the limitations of automatic stabilisers, which are the fundamental factor underpinning the Pact, and the relationship between public spending and economic growth. A proposal for an alternative procedure for rainy days is subsequently presented.

<table>
<thead>
<tr>
<th>Table 1</th>
<th>Growth and Deficits 2002-2004</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>GDP%</td>
</tr>
<tr>
<td></td>
<td>2002</td>
</tr>
<tr>
<td>France</td>
<td>1.3</td>
</tr>
<tr>
<td>Germany</td>
<td>0.2</td>
</tr>
<tr>
<td>Italy</td>
<td>0.4</td>
</tr>
<tr>
<td>Portugal</td>
<td>0.4</td>
</tr>
<tr>
<td>Netherlands</td>
<td>0.2</td>
</tr>
<tr>
<td>Greece</td>
<td>3.9</td>
</tr>
</tbody>
</table>

*Source: EMU Commission Services, April 2004*
The Pact’s Provisions for “Rainy Days”

According to the Pact, each Member State must pursue a medium term goal: a budget close to balance or in slight surplus. In any case, the deficit cannot breach the limit of 3 per cent of GDP. However, the Pact allows Member States to breach this value in case of a “severe” or “exceptional” recession. The Pact does not directly provide for the case of a serious slowdown or mild recession. It provides two indirect ways of dealing with problems arising from protracted low economic growth namely (a) a “preventive” way whereby EMU Member States are advised to avoid profligate policies during upswings, and (b) a degree of flexibility within the EDP by which the Commission exercises discretion in determining when the deficit is excessive and how much time a country is given to correct it.

According to the European Commission, Member states that did not relax fiscal policy during economic upswings faced successfully the problems arising from the subsequent slowdown. Analysing the crisis of November 25, 2003, the Commission’s economists determined that its roots lay in the more expansionary fiscal policy stance in the immediate aftermath of the 1999-2000 economic upswing adopted by the French and German governments.

Buti and Van den Noord (2004) argue that the crisis has “much to do with a weak system of incentives for resisting a politically motivated fiscal behaviour”. According to this line of thought, Member States should follow symmetrical fiscal policies over the economic cycle, in order to face economic slowdowns without incurring an excessive deficit. In particular they would be expected to run budget surpluses during economic upswings which could be useful in the downturns which follow.

On the other hand, it must be admitted that the system of incentives for resisting politically motivated budget policies during the upswings is weak. This phenomenon is well documented in the literature on time inconsistency, which is based on governments’ incentives to exploit good economic times, repudiating previous commitments. Politically motivated fiscal behaviour must thus be considered as a “deep” parameter which is not easily modifiable. This is particularly true in a context characterised by low growth prospects and where the upswings are rare.
and uncertain. This means that the applicability of the Pact through the “preventive” approach is difficult to implement and is likely to result in crises during rainy days.

The provisions of the Pact allow for a significant degree of flexibility in meeting the deficit to GDP reference value. The Pact affords latitude to the Commission in determining whether a deficit is “excessive”. The EU Council held in Gothenburg (Sweden) in 2001, decided that the Commission should consider, in determining whether a deficit is excessive, the structural, or cyclically-adjusted deficit. In this regard, the Commission should also consider whether the deficit is due to investment expenditure or to structural reforms which may take long to produce positive effects (IMF, 2004a). Moreover, the Treaty gives the Commission some discretion in determining if a decline in output constitutes an exceptional event.

The degree of flexibility is enlarged by the EDP, which gives the Member State for which the procedure has been opened, some leeway in adopting fiscal corrective measures to bring the deficit to GDP ratio below the reference value of 3 per cent. De facto a country can count on a period of three or four years to correct the deficit. Indeed, according to Bini Smaghi (2003), in November 2003 there should have been further room to bargain a new delay in the final recommendation of the Commission. Gros et al. (2003) observe that even if the Commission’s recommendation had been then accepted, sanctions could have been imposed on France and Germany only in the event that they had not complied with this recommendation.

The EDP has a political cost to the Governments of countries involved in it. But Buti and Van den Noord (2004) observe that the EDP, “although essential, kicks in when harm is already done.” The relative sanctions arrive too late, if at all. Moreover, the procedure is not sufficiently clear since Member States do not know how they will be treated when they cross the 3 per cent threshold (IMF, 2004a). Finally, the flexibility provided by the Treaty and by the Pact is of an ex-post nature and as such, reduces the incentives for countries to implement fiscal reforms (Buiter and Sibert, 1997), encourages moral hazard behaviour and reduces credibility (Verde, 1999). To sum up, the flexibility provided by the Pact is substantial but its “quality” is low. This implies that the degree of flexibility within the Pact is unlikely to prevent crises during rainy days.
It would be far preferable if such flexibility would be of an ex-ante nature. This requires the numerical rules of the Pact to be more flexible, while the procedural rules should be more predetermined.

The foregoing discussion on fiscal policy during different phases of the economic cycle, and on the desirability of flexibility within the Pact to account for fundamental economic growth conditions, lead to the need to consider the role of automatic and discretionary fiscal policy stabilisers, and the relationship between government spending and economic growth.

**Automatic and Discretionary Stabilisation**

The automatic stabilisation process\(^1\) is the linchpin of the rationale of the Pact. According to the Pact, starting from a situation close to balance, the government should limit itself to allow the automatic stabilisers to operate freely and make them more effective (Buti and Van den Noord, 2003). Automatic stabilisation contrasts with discretionary fiscal policy intervention. The preference for automatic stabilisation has its roots in the economic theory that puts the emphasis on the well-known lags involved in discretionary fiscal policy, namely lags in the diagnosis of the current cyclical phase, in the implementation of the corrective measures and in their impact on the economy. The more probable consequence of these three lags is a pro-cyclical budget policy.

However, an exclusive reliance of fiscal policy on automatic stabilisers entails a number of risks which are often neglected. For instance, governments may treat changes in budget positions that have structural roots as if they were the result of automatic stabilisers, or vice-versa, and this may lead to inappropriate policies. Automatic fiscal stabilisers respond to structural changes in the economic situation as well as to cyclical developments. Consequently, if the economy’s growth potential declines, and this is not addressed by the government in a timely fashion, the operation of automatic fiscal stabilisers is likely to undermine the public finance position that might otherwise have been sound (Buti and Van den Noord, 2003).

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1. Automatic stabilisers are mechanisms connected with the evolution of some items of the public budget, such as taxes and unemployment subsides, that react automatically to the GDP fluctuations, tending to stabilise them.
Stability and Growth Pact in Rainy Days

In the debate on the Pact, automatic stabilisers have been discussed from two viewpoints. The first is whether the margins allowed by the reference value were sufficient, starting from a situation close to the balance, to permit member states not to breach it during slowdowns. According to Buti et al. (1997) the margins afforded by the Pact in this respect are adequate. The second is whether the Pact itself has reduced the stabilising effects (automatic and discretionary) of fiscal policy. Gali and Perotti (2003) find that the Pact has rendered fiscal policy more counter-cyclical. But this view is challenged by Fatas et al. (2003) and IMF (2004), who show that public finances have been pro-cyclical in the period 1992-2002, particularly during economic slowdowns. Pro-cyclical fiscal policies are particularly evident in the period 1992-1998 when governments engaged in fiscal consolidation in order to join EMU, regardless of their business cycle. After 1998, the cases of pro-cyclical fiscal policies have diminished.

But this risk of pro-cyclical fiscal policy is high when a Member State is in a slowdown and is far from the budget balance. Experience shows that in such a situation a country is prone to (a) adopt pro-cyclical policies that penalise, in particular, investment spending since it can be restrained more easily, and (b) resort to one-off operations, securitisation of government assets, or creative accounting, that would often worsen the future prospects for sustainable fiscal policy (Milesi-Ferretti, 2003; Cangiano and Ter-Minassian, 2003).

It is important to add a further dimension to this debate concerning the extent to which an asymmetric shock can be absorbed by automatic stabilisers. Barrel and Pina (2002) find this to be very low, varying between 5 and 18 per cent, with an EMU average of 11 per cent. Thus, in the case of protracted slowdown, it is important to have a discretionary stabilisation function apart from the automatic one. This would be best done in a way which focuses on increasing high quality spending that favours economic growth.

High Quality Spending and Economic Growth

Public finance has important implications for long-term economic growth and for the evolution of domestic demand in the short-run. On the revenue side, a conclusion that seems to have gained a wide consensus is
that shifting taxation from factor incomes to consumption has a positive and lasting effect on economic growth. Fatas et al. (2004) confirm that in Europe, there is a negative correlation between the overall tax burden and GDP growth and that the rate of growth is lower when direct taxation is higher.

However there are more contrasting opinions on the link between public spending and growth. Usually, empirical research focuses on the econometric relationship between public investments and long-run growth, producing disparate results. Many economists believe, for various reasons including crowding-out and Ricardian Equivalence, that the link between public expenditure and growth is weak, null, or even negative. It is certainly difficult to verify through econometric estimates, even very sophisticated ones, a link between public investment and growth which is statistically meaningful. The channels through which public investment influences growth are also not clear. However, we can reasonably believe that some high-quality public spending should have a positive impact on the economic growth of a country, especially when it comes to infrastructures, investments in R&D, in communications, in education and so on.

A recent IMF paper on public investment and fiscal policy provides a long list of empirical work that found a positive relation between public investment and growth (IMF, 2004b). The same paper states that “increased priority should be given to spending on needed and well-designed infrastructure projects in budget allocations”; “room should be created, at least beyond the very short-term, to protect high-priority projects when fiscal adjustment is required”; “the scope for increased financing of new public investment that is consistent with short term macroeconomic stability and long term debt sustainability should be fully utilised”; and “the possibility that a declining share of public investment in GDP could have adverse consequences for economic growth over the longer term is a legitimate cause for concern”. Fatas et al. (2004) detect a high correlation between public investments, as a percentage of GDP, and GDP changes in EMU during 1992-2002 and, at the same time, a negative correlation between social transfers and growth. It thus appears that more than the overall deficit, it is the composition of public spending that is relevant for economic growth. This argument provides the basis for the adoption of a golden rule towards introducing more ex-ante flexibility in the Pact.
Golden Rule: Advantages and Flaws

The golden rule implies a dual budget which distinguishes current transactions from those in the capital account. Under the golden rule regime, governments are only allowed to borrow to finance public investment. Musgrave (1939) suggested that the golden rule be used to stimulate public investment or, better still, to remove the bias against capital expenditure.² The single states of the USA, the German Lander and the German federal government have already been using the golden rule, whereas the British government applies a golden rule coupled with a debt constraint (Kell, 2001).

Despite being intuitively appealing, the golden rule has met with important criticisms. First of all, the golden rule represents a permanent engine to spur public investment spending and to limit public consumption spending. However, according to some recent estimates (Balassone and Franco, 2001), it could hinder the achievement of the Treaty’s other fiscal objective—the reduction of the debt/GDP ratio to 60 per cent.³ Secondly, public investments usually materialise long after an economy needs an expansion in aggregate demand because of time required for project selection, authorisations etc., such that their impact may prove to be pro-cyclical. Thirdly, the golden rule prevents an incentive to governments to classify current expenditures as capital spending. Finally, the golden rule leads governments to prefer investment in physical assets rather than in human capital, as a substantial part of education and health programs are classified as recurrent spending, in spite of their important contribution to potential growth.

There is another feature which deserves consideration in this context. This is related to the ability of the golden rule to spread public investment costs on to future generations, which will pay for the investments and will benefit from them. The Pact however works in the opposite way: its medium term objective—a budgetary position close to balance or in

². It is possible that the Maastricht Treaty drafters had the golden rule in mind, since, when the Treaty was signed, public investment spending in the Monetary Union, as a whole, amounted to some 3 per cent of the EMU GDP, a percentage considered by the Treaty as a “not excessive” deficit.
³. It is for this reason the British government adopts a golden rule coupled with a debt constraint.
surplus—implies that capital expenditure must be funded from current revenues. Therefore, the cost of public investment is sustained by the present generation of taxpayers, while future generations will benefit from it. Therefore, the Pact provides a disincentive to undertake public investments that produce deferred benefits (Balassone F. and Franco D., 2001).

A New Proposal to Reform the Pact

There have been various proposals to reform the Pact, the principal ones being summarised in Table 2. Of these, proposals based on the golden rule are clearly consistent with the idea that the budget composition is important. It has a number of flaws, but these become less important if the rule is applied on a temporary basis.

Table 2
The Main Proposals to Reform the Stability and Growth Pact

<table>
<thead>
<tr>
<th>Old Approaches</th>
<th>New Approaches</th>
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<tbody>
<tr>
<td><strong>Alternatives:</strong></td>
<td><strong>Delegation Approach:</strong></td>
</tr>
<tr>
<td>• Procedures (von Hagen-Harden, 1994);</td>
<td>• Wyplosz’s FPC (2002);</td>
</tr>
<tr>
<td>• Fiscal federalism (MacDougall Report, 1977);</td>
<td>• CEPR-ZEI (2003);</td>
</tr>
<tr>
<td>• Stabilisation fund (Majocchi and Rey, 1993);</td>
<td>• Brunetta and Tria (2003).</td>
</tr>
<tr>
<td>• Deficit permits (Casella, 1999).</td>
<td><strong>Gradualist Approach:</strong></td>
</tr>
<tr>
<td><strong>New Rules-based System:</strong></td>
<td>• Commission proposal (3 September 2004);</td>
</tr>
<tr>
<td>• Debt rule (Pisany Ferry, 2002);</td>
<td>• Buti et al. (2003);</td>
</tr>
<tr>
<td>• Intertemporal budget rule (Buiter, 2002);</td>
<td>• Gros et al. (2003).</td>
</tr>
<tr>
<td>• Ceiling on expenditure (Alesina, 2001);</td>
<td><strong>Eclectic approach:</strong></td>
</tr>
<tr>
<td>• Golden rule (Musgrave, 1939)</td>
<td>• IMF (2004a).</td>
</tr>
<tr>
<td>• Blanchard and Giavazzi (2003);</td>
<td></td>
</tr>
<tr>
<td>• Verde and Monorchio (2001);</td>
<td></td>
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<tr>
<td>• Verde (2002).</td>
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</table>
This is the starting point of the Verde-Monorchio (2001) proposal. It builds on the escape clause in the Pact regarding “severe” and “exceptional” recessions, which however does not consider instances of sharp slowdown or mild recession. Verde and Monorchio (2001) propose to temporarily exclude high quality public spending from the computation of the fiscal deficit in conditions of actual or expected sharp slowdown or mild recession. The proposal specifies that high quality spending does not encompass all public investment, but a particular kind of capital expenditure capable of enhancing potential growth and improving the long-term sustainability of the fiscal budget.

Within this line of thinking, there is an important communication prepared by the Commission in the run-up to the Stockholm EU summit of March 2001 that stressed the role and the definition of high quality spending. The latter is defined to include expenditure on infrastructure, innovation and R&D and investment in human capital (European Commission 2001). This communication attempts to target the problems of defining “high quality spending” and of misclassification between current and capital expenditure.

Typical of all escape clauses, the temporariness inherent in the Verde-Monorchio proposal aims at reducing the negative effects of the permanent golden rule, in particular those relating to public debt and the incentives towards misclassification. Moreover, the adoption of the Verde-Monorchio proposal is subject to the authorisation of the Commission, which should verify the quality of the public spending.

Verde (2002) attempts to improve on this proposal by providing for the automatic exclusion from the Pact’s constraints of the Member State co-financing expenditure in European Structural Funds Programme. The high quality of this spending would have been previously settled between Member States and the Commission. This provision is aimed at reducing, in some way, the duration of the procedure between the Commission and the concerned country to verify the high quality of the expenditure to be excluded from the Pact’s constraints.

4. Unfortunately some definition and measurement problems still remain, particularly in the case of spending in human capital which provides a formidable inventive for dubious accounting practices
The proposal presented in this paper is based on the following points, partially drawn from Verde and Monorchio (2001) and Verde (2002). The roots of the crisis of the Pact are to be found in the low economic growth in the EU, for which the Pact makes no special provision. Indeed, the current escape clause refers to cases of “severe” or “exceptional” recessions which represent rare events. The automatic stabilisation implied in the Pact is not sufficient to face a protracted period of low growth and it is therefore necessary to pay attention to the quality of public spending. It is possible to conceive a new escape clause within the domain of the golden rule to make the Pact more flexible. But because of flaws in the golden rule itself, the new escape clause should have only a temporary application, limited to the year(s) of marked slowdown.

In addition, the new escape clause must be simple, quickly adoptable and adequate relative to the final goal. It should be also conducive to enhance the credibility of the Pact and implemented by the existing European institutional fiscal frameworks, avoiding the creation of new “independent” agencies. Finally, the deficit measure considered in the proposal is the actual and not the cyclically-adjusted one, so as to avoid difficulties arising out of estimating the output gap and revenue and expenditure elasticities.

An essential element of this proposal concerns the redefinition of “exceptional circumstances” in which an excessive deficit is allowed. The new escape clause could trigger in the case of low economic growth, such as for example, when the GDP increase is equal to or lower than 0.5 per cent, about one point less than the European potential output. In practice, the new escape clause would enter into effect when, in the previous year, the increase in GDP has been equal to, or less than 0.5 per cent. Then, if in that year, a Member State has recorded a deficit to GDP ratio higher than 3 per cent, the State is given the opportunity to exclude from its total spending those expenditure elements outlined in the Commission’s paper as being of a high quality nature. Only if after this adjustment the deficit to GDP ratio is still higher than 3 per cent would the Member State enter into the Excessive Deficit Procedure.

This proposal can be evaluated against the characteristics of an ideal fiscal rule as identified by Kopits and Symansky (1998), and Buiter (2002) namely simplicity, transparency, credibility and enforceability.
The new escape clause is “simple”, as the items to be excluded from the Pact’s constraint can be clearly identified. It seems possible, both conceptually and statistically, to draw from the national budgets these items using homogenous data for all EMU Member States. However, in order to face the current crisis, two other characteristics of an ideal proposal to reform the Pact should be considered. These refer to the fact that it should be rapidly adoptable and adequate for the attainment of the desired goal.

When considering the first issue, three further pre-requisites are necessary. In particular, the proposal should not require the revision of the Maastricht Treaty; secondly, it should be profitable for all the EMU Member States to adopt, and finally, its application must be automatic. By applying these criteria to the proposal presented in this paper, we observe that it is doubtful whether the new escape clause would imply a change in the 3 per cent reference value.

In any case it is the SGP that should be modified rather than the Treaty, because the proposal redefines the conditions under which the escape clause would be triggered, which is provided by the SGP. Secondly, the benefit allowed by the Pact’s loosening during slowdowns represents a potential advantage for all EMU countries. Finally, at least in its ex-post version, the new escape clause may be automatically applied. Thus, for these reasons, the new escape clause could be promptly adopted.

With regard to the second aspect, namely the adequacy to achieve the desired goal, reference is made to Italian data as shown in Table 3. The table presents data on expenditure on infrastructure, research and innovation in Italy, which is at this point available only for the year 2000. If the new escape clause were to be adopted, it would significantly reduce the impact on the nominal deficit/GDP ratio. In this preliminary estimate of “high quality” spending, the reduction in deficit/GDP ratio amounts to 1.3 percentage points. Some preliminary estimates for the period 2001-2003 lead us to believe that these values have remained essentially stable.

Within the ambit of this proposal, it is the Commission which will continue to decide the pace at which the Member State must bring the deficit/GDP ratio below the 3 per cent threshold. In its decision, the Commission would take into account all the factors, past and present, which synthesise a Member State’s attitude towards the fiscal rule.
Thus the Commission would be expected to consider if the government has adopted sound policies or is going to carry out structural reforms.

Another important feature of this proposal is that its ex-ante flexibility tackles the problem of the undermining of credibility generated by the flexibility of the EDP. For instance, the procedure should begin in the year following that in which the reference value of 3 per cent has been breached and should end in subsequent year.

The New Escape Clause: The Ex-Ante Version

The new proposal can be essentially conceived as a change of the current escape clause, or better still, of the threshold which triggers it. The current threshold is equal to −0.75 per cent or −2 per cent whereas the proposed one is equal to + 0.5 per cent. Moreover, unlike the current practice, the new escape clause could be adopted ex-ante. In this case, it refers to the expected rate of GDP increase which must be equal to, or less than the 0.5 per cent.

In this case a member state will be allowed to detract from the final total outlays the amount of high quality spending actually undertaken in the

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**Table 3**  
High Quality Spending: The Italian Data (2000)

<table>
<thead>
<tr>
<th>Gross Investment Public works (1)</th>
<th>Net Investment Public works (2)</th>
<th>Research (3)</th>
<th>Total (2)+(3) (4)</th>
<th>Technological Innovation Fund (5)</th>
<th>Total (4)+(5) (6)</th>
</tr>
</thead>
<tbody>
<tr>
<td>EUR (M)</td>
<td>10,124</td>
<td>6,439</td>
<td>6,221</td>
<td>12,660</td>
<td>1,779</td>
</tr>
<tr>
<td>% GDP</td>
<td>0.9</td>
<td>0.6</td>
<td>0.5</td>
<td>1.1</td>
<td>0.2</td>
</tr>
</tbody>
</table>

Sources:
2. The depreciation has been estimated as quota of the item “Depreciation” of the Italian Public Administration.
3. ISTAT.
year under consideration. If the Stability Program of a Member State for the next year foresees a real growth below the 0.5 per cent, the new escape clause allows the exclusion of high quality spending from the Pact’s constraints.

If, on the basis of final data, the deficit, net of high quality public spending actually undertaken, is less than 3 per cent of GDP, there is no excessive deficit. Otherwise the deficit will be excessive and the relative procedure would commence. The new escape clause ought to be applied even if, ex-post, the actual rate of economic growth is higher than 0.5 percent.

In this ex-ante version, the new escape clause is more meaningful from an economic point of view, but it is also obviously weaker (Imman, 1996; Buti et al., 2003) because it takes into account expected data and this could be a source of opportunistic behaviour. This could happen because governments could manipulate macroeconomic and fiscal policy forecasts and the higher deficit to GDP ratio allowed only for high quality spending could be instead utilised to cover higher current spending.

In general, the risk of manipulation of the economic forecasts is more than well-founded (Milesi-Ferretti and Moriyama 2004). Over-optimistic forecasts are typical of governments with public budget problems. But things would change radically when a Member State claims the enforcement of the new escape clause: the risk moves to the opposite direction. In this case, in fact, the government is interested in forecasting a gloomy year, since the escape clause is triggered only with an economic growth lower than 0.5 per cent.

On the other hand, the risk that governments will be tempted to use the “space” allowed by the new escape clause for high quality spending with current spending is to be taken seriously. But this can be faced in an effective way. The Commission should verify the reliability of national forecasts regarding public budget items.

To prevent abuse of the system, the Commission could require that the expected level of current spending should not be higher than that of the previous year by a pre-fixed amount, i.e. fixed according to the increase
in nominal GDP, if the Member State concerned claims the adoption of the new escape clause.

The purposes of this ex-ante version of the new escape clause are quite different from those seen previously regarding the ex-post version, and include:
a) to allow the Member State to exploit the public budget in facing a downturn and to avoid a further worsening of the cycle;
b) to enhance long-term growth and to assure fiscal sustainability even if the deficit/GDP ratio can breach the 3 per cent reference value;
c) to provide the Pact with a new escape clause whose benefits are in principle available to all Member States, when the pre-condition, a growth lower than 0.5 per cent, occurs.

Some Concluding Remarks

The proposal presented in this paper involves changing the Pact under many aspects. These include redefining the “exceptional circumstances” in which an excessive deficit is allowed, binding the benefits of the new proposal to the realisation of high quality public spending, enhancing the Excessive Deficits Procedure thereby making it more credible and finally, widening the role of the Commission with regards to macroeconomic forecasts and the power to determine the path of re-entry of the deficit below the reference value of 3 per cent.

These reforms are necessary because the SGP pays too much attention to the deficit but overlooks the quality of public finance as well as the problems posed by downturns. The new proposal does not illustrate a way to utilise public investment for a cyclical support. It simply aims to avoid a reduction in high quality public spending that may occur during a slowdown because of the Pact’s fiscal constraints. The EMU countries have a particular need to increase public spending in innovation, infrastructure and in human capital in order to face the current challenges created by globalisation.

The new proposal can be essentially conceived as a redefinition of the current escape clause, and furthermore, the new escape clause could be adopted ex-ante.
References


